New City Agenda

John Kay Lecture

15 March 2016

Introductory Remarks

Lord Sharkey

Founding Member, New City Agenda

Good morning, ladies and gentlemen. John will speak for a while and then will be happy to answer questions. I would like to welcome our speaker this morning, John Kay. John really needs no introduction. He will be familiar to all of us from his books and his *FT* columns, and to some of us from his appearance in front of parliamentary committees. John is one of the country's most distinguished economists and economic commentators. He has written books, one with Mervyn King. He has been a director of the IFS, which the *Guardian* described this morning as 'the most powerful voice in British economics'.

John has paid very close and critical attention to the financial crisis and his aftermath, and he has described his general approach of having four components. The first is telling it like it is. The second is recognising that markets operate in a social context. The third is that consistency is an overrated axiom. The fourth is that economics ought to be studied in a pluralist manner. I am sure we will hear all those principles in action this morning, John.

Other People's Money: Masters of the Universe or Servants of the People

Professor John Kay

Economist

I. Transition

1. Banking in the Old Days

Thank you. I do not quite know where that came account from, but it is a better description of my philosophy than any I can imagine. Thank you for that. Going back more years than any of us would care to remember, I was a schoolboy in the 1960s in Edinburgh. In these days, banking was a job for the boys in my class who were not going to get quite good enough grades to go on to good universities. They would join the Bank of Scotland or the Royal Bank of Scotland and, if they worked hard, after 20 years or so they would become branch managers. They would spend a lot of time at the Rotary Club or on golf links and they expected to retire, after another 20 years, with a good pension from the Bank or the Royal Bank, having spent their entire careers at a single institution.

2. Banking in 2008

By the time that the Bank of Scotland and the Royal Bank of Scotland had gone bust in 2008, these classmates of mine had mostly gone into early retirement. The Bank and the Royal Bank were run by people who had very good degrees from very good universities. Some of them had MBAs from excellent business schools. They ran the banks, as is evident from the results, not just worse, but much worse, than the boys who were in my class at school.

3. Transaction-based Finance

That is a symbol of the transition from the relationship -based finance, which was the dominant strand of financial activity into the 1970s, to the transactions- and trading-based world of finance that we live in today. That transition is the process that I call in my book *Other People's Money* 'financialisation'. It is not an original term; it is not a term I very much like, but it reflects the ways in which the financial system has both changed its nature and become much more central to our economic system.

II. Effects of Financialisation

1. Economic Instability

Financialisation has had a range of effects. It has produced more economic instability. People often think that the world is one in which financial crises are simply endemic. If we look at history that turns out not to be true. From the Second World War to the 1970s, we enjoyed a period of unprecedented financial stability, which was then followed in this era of financialisation by a steady increase in the incidence of however you choose to measure financial crisis – banking failure, stock market disruptions and the like.

2. Inequality

At the same time, we have also seen a reversal of what was the quite marked trend in reducing inequality across the first half of the 20th century. I used four different countries for this kind of measure. In all of them – Britain, France, Germany and the United States – the share of the 1%, which is the thing that occupies protestors and is ranted about in New York and in St Paul's Churchyard, decreased by about a half between the beginning of the century and 1970. In France and Germany that share flattened out. In Britain it has risen sharply. In the United States it has risen to levels at which it exceeds the levels of inequality from the beginning of the century. If we look at the composition of the 1%, we find that the dominant groups driving that are people who work in finance and senior corporate executives. Some of the broader economic effects of financialisation are to do with inequality and instability.

III. Transactions and Trading

1. Volume of Trade

What is this world of transactions and trading that we have created? Let me give some examples to illustrate a central fact of modern financial life, which is that, if you ask what people in the wholesale financial sector do, what they do overwhelmingly is to trade with each other. The volume of world trade in goods and services has expanded very rapidly. The volume of trade in foreign exchange markets is, today, about 100 times the underlying volume of trade in goods and services.

2. Lending

Probably a lot of the people in this room still think that what banks do is to take deposits from savers and lend them out to business. Actually, lending to non-financial business accounts for less than 3% of the total assets of British banks today. The total volume of outstanding exposures under derivative contracts is of the order of $600 trillion. That is a mind-blowing figure. It is actually between two and three times the total volume of all the assets of the world. Two banks, JPMorgan and Deutsche Bank, each account for about 10% of that total. In the case of Deutsche Bank, that is not just a high proportion of all the assets in the world; it is two to three times the value of all the assets in Germany.

3. Algorithms

Some of you may know or have read in Michael Lewis's *Flash Boys* about this telecoms link that Spread Networks, a US company, has built across the Appalachian Mountains. Its purpose is to reduce the time it takes to transmit data from Chicago to New York from 7.3 milliseconds to 6.6 milliseconds. None of us can visualise a millisecond. To give you an idea of what that means, the irreducible physical limit to that figure is 4.3 milliseconds, which is the time it takes light to travel from Chicago to New York. We are not quite there yet, but we are getting there. Since a millisecond is irrelevant to any human being, the purpose of speeding up the link is to enable the computers at each end of any particular trade to talk to each other more effectively. In effect today, we are using some of the best mathematicians in the world to program trading algorithms to try to outsmart other mathematicians programming other trading algorithms.

4. Purpose

What is all this for? What is the point of all this activity? There is an ancillary question about why it is actually so profitable. These are some of the questions I wrote my book to analyse but, having raised these questions, I want today to start at the other end of the spectrum and ask what we want a financial system for in the first place. Modern economies need finance and we have never had prosperous societies that have not had an effectively functioning financial system. If you ask what they need finance for, in my view, they need it for four things.

IV. The Financial System

1. Payments

First, we need finance to operate a payment system. This is the basic utility in which we buy and sell goods and services, receive our wages and salaries and in which ordinary businesses transact with each other. The payment system is particularly interesting at the moment, because it is probably the area of finance that is most on the cusp of potentially fundamental disruption. I suspect that, in 20 years' time, our grandchildren will be very surprised by the idea that we walked around with folding bits of paper in our pockets and probably quite surprised by the idea that we had large sums of money on deposit at banks. These things are potentially rendered wholly redundant by advances in electronic technology that have already happened. Operating the payment system is actually what most people in finance do. They are not masters of the universe; they are employed in relatively mundane clerical jobs in branches and call centres.

I have talked about the share of the 1% of total income in British and other economies today. That is even more marked if I look at financial institutions themselves. When I looked at the remuneration structure of Barclays Bank, I estimated that the top 1% of Barclays employees account for about 40% of the total remuneration of employees at Barclays Bank. The majority of people who work for that institution earn less than £25,000, which is below the British median wage. Most people are working in that core utility, but that is not what people in wholesale finance are doing.

2. Wealth Management

The second thing we need finance to do is wealth management, which is a term that has been appropriated by people who sell rather expensive services to so -called high -net- worth individuals. By 'wealth management', what I really mean is the business of smoothing our consumption over our lifetime. We need to finance education when we are young, then we typically need to buy houses and provide for retirement. We want to pass some or all of our wealth on to subsequent generations and we need a financial system to help us do that.

3. Capital Allocation

a. Securities issuance

Thirdly, we need a financial system to engage in capital allocation. If you ask people in the City what finance is for, they will put a lot of emphasis on the role of finance in capital allocation. When Lloyd Blankfein gave a famously foolish interview to the *Times* back in 2009, in which he said that Goldman Sachs was 'doing God's work', and when the interviewer probed a little as to what the deity had in mind in appointing Goldman to this role, Blankfein went on to explain that what Goldman did was, through securities issuance, help companies raise capital for investment. He said that was then ploughed back into creating jobs and wealth, which then went back into further securities issuance through the good offices of Goldman and was translated into further jobs and wealth. It was a virtuous circle, he explained.

There are two mistakes in that. One is in thinking that securities issuance was a large part of what Goldman Sachs actually does. Over the last 10 years, it has accounted for less than 10% of their total revenues. As most of us know, the bulk of Goldman Sachs' revenue comes from market-making and trading of various kinds in secondary assets.

b. Self-financing

The second point was to think that securities issuance was the way in which the kinds of companies that are Goldman clients raised capital for investment. It is not. Large and listed companies today are overwhelmingly self-financing, both individually and in aggregate. They raise more than enough cash from their operations in order to fund their investment needs. Even a heavily capital intensive company like ExxonMobil, which has the largest investment programme of any company in the world, now owns more in the way of shares head in treasury that is has brought back using into surplus cash flow than it does in the way of physical, tangible operating assets.

As I say, ExxonMobil is unusual, because it is a capital -intensive company. Modern corporations, like Apple, Google, Facebook and Microsoft, are capital -light and typically cash -generative well before they even get to the stage of a listing. Apple's market capitalisation today is between $500 and $600 billion. The tangible operating assets of that business are less than $20 billion. To the extent that a business like Apple uses capital at all, it is mostly fungible. It does not need to be owned by the business that operates it and typically is not. Many of you will have been in Apple's flagship store in Regent Store, but you have probably not asked the question who owns that store. The answer, rather interestingly, is that it is jointly owned by the Queen and the Norwegian sovereign wealth fund. That is the nature of capital ownership in today's economy; it is diffused but in this rather different sense. I refer to the Queen, as owner, but the revenues from the Crown Estate actually go back into the Treasury.

c. *Changes to businesses*

These kinds of businesses are very different from the ones that the stock markets we know came into being to facilitate, which were the railways and railroads of the 19th century. These were very capital- intensive businesses. The savings to finance them came in penny packets from large numbers of fairly affluent private individuals, and the stock market facilitated that kind of capital raising and provided liquidity for the people who invented them. That model was then adapted to breweries, automobile plants and petrochemicals for the large manufacturing corporations that were typical of the first half to the 20th century. Business is just not like that anymore.

d. *Productive investment*

We are going to hear a lot more in the next couple of days about productive investment, (the budget was delivered the following day) but that does not quite recognise how relatively unimportant business's physical investment now is to our overall picture. If we look at what the capital stock of the UK consists of today, we discover that 60% of British it is housing. Housing is overwhelmingly the dominant long- term physical asset. The remaining 40% divides roughly equally between infrastructure, non-residential property, such as shops, offices and the like, and business investment.

e. *Housing*

Capital allocation is overwhelmingly about housing and, if you ask what banks actually do for the non-financial economy, the main thing they do is to take deposits and lend on residential mortgages. That is not a terribly difficult business. It is a business that could have been done perfectly well by those boys in my class whom I was describing at the beginning. Actually, it was not these boys; it was the boys at the top of the class below my class, who were not quite good enough to get jobs in the Bank of Scotland and the Royal Bank of Scotland, but did get jobs in building societies. They went to the Halifax and the Dunfermline Building Societies, they became managers there and they made mortgage loans. These judgments turned out rather better than the computerised algorithms that displaced them in the early years of the 20th century. The nature of capital allocation, in this basic sense, has changed.

f. *Search*

In my view, the capital allocation activities that we need today consist of search, by which I mean looking for new investment opportunities. Given the changes in the nature of business that I have described, search mainly means looking for the next generation of new businesses and funding their operating losses until these businesses become cash-generative. That is the large funding gap we have at the moment and rather little of the capital allocation system that Lloyd Blankfein and others were describing is adapted to that purpose.

g. *Stewardship*

The other part of capital allocation is stewardship, which is essentially the management of the assets that we already have, whether they are infrastructure assets or whether they are housing assets. That is now largely dealt with by the view (which I share) that, in the main, owner-occupiers are the best stewards of our housing stock. We have not quite cracked the problem of stewardship of the remainder, and social housing is something to which we need to direct investment. As I was describing, business investment is predominantly now done by internally generated funds.

4. Risk Management

a. Jackson Hole warning

The final area that people in wholesale financial services talk about is risk mitigation and management. If you ask what financial innovation has done for the economic system over the last 20 or 30 years, through this process of financialisation, risk management will be a high priority. I would go back to a famous conference at Jackson Hole in 2005. Some of you may know that, every year in August, the Federal Reserve Bank of Kansas holds a meeting at Jackson Hole. This is a rather agreeable ski resort in the mountains of Wyoming, and bankers do not have a lot to do in August, so the Kansas Bank is very good at getting the great and good of the financial world to fly in and attend this conference. The 2005 one was quite special, because the subject was the Greenspan era, because it was the last of these events before Alan Greenspan retired in 2006, after 20 years as Chairman of the Federal Reserve Board.

There was a guy who went along to that event rather determined to spoil the party. His name was Raghuram Rajan. At that time, he was Chief Economist of the International Monetary Fund. What Rajan did was to deliver a paper in which he said that what was happening in the financial world was that a lot of long-tail risk was being assumed within the system in ways that were likely, at some time in the future, to end in tears. You will not be surprised to know that Rajan's paper did not go down very well at that event. He was denounced by his discussant, Don Kohn, who explained that Rajan had misunderstood what was going on and actually what was happening was the diversification and pooling of risks within the financial system, which rendered the system more resilient and robust. Larry Summers was even more vigorous in his denunciation than Kohn. Summers said that Rajan wanted to take finance back to the era of coaches and horses; he was a Luddite of the financial world. Other people like Tim Geithner and Ben Bernanke joined in the denunciation of Rajan.

b. The unimportance of being right

One lesson that I tell students when I talk about this incident is what a colleague of mine once called 'the unimportance of being right'. The breath-taking scale of the misapprehensions of Kohn, Summers and the like was not an obstacle to their subsequent advancement. Bernanke of course went on to become Chairman of the Fed, as the successor to Greenspan. Don Kohn became his Vice Chairman. Tim Geithner became Treasury Secretary under Obama and Larry Summers, Chief Economic Adviser to Obama. Rajan, on the other hand, left his job at the IMF. We should not weep too many tears for him, because he went back to India and, in due course, emerged in the position he holds today, which is Governor of the Reserve Bank of India. Still, the whole story is an illustration of Keynes' dictum that it is generally better to be conventionally wrong than to be unconventionally right.

c. Global insurance models

There were two mistakes made by these protagonists at Jackson Hole. One was that they misunderstood the nature of the risk transfer that was taking place. It is important that we understand, when talking about markets and risk, the two motives that there are for people transferring risks from one to another. The best illustration that I know of that comes from a book written by the French economist Michel Albert, who became Chief Executive of a large French insurance company. He described two origins of the global insurance market.

One was the Swiss villages of the 18th century, in which the villagers got together and set up institutions to mutualise the risks that were involved in the rather hostile environment of 18th-century Switzerland. To caricature a bit, they agreed that, if one of their cows died, the village would club together and buy another. As these people became richer and more sophisticated, they descended from their mountain pastures and are today running the large behemoths of the global reinsurance world in Munich Re, Swiss Re, Zurich Re, etc.

The other origin was in Lloyd's of London, where 18th-century English gents would gather to drink coffee and to gamble. They would gamble on more or less anything. They would gamble on the health of the King, the fate of Admiral Byng and the results of battles that the British Army and Navy were fighting around the world to develop the Empire. They would gamble on the weather and the fate of ships at sea. Merchants realised that going to Lloyd's coffee shop was a method by which they could lay off some of the risks associated with trading ventures, and that was the mechanism by which Lloyd's became the centre of the world's marine insurance market that it still is today.

d. *Gambling motives*

The key point to take out of this was that you can transfer risks, as they were doing in Lloyd's coffee shop, because people were taking different views on the outcome of the same event. That is essentially the gambling motive for risk transfer, or there is the mutualisation motive, in which you take on board the idea that you can minimise not the risks but the cost of bearing the risks, by sharing them and pooling them in large groups and organisations. There are always these two motives behind any sort of risk transfer.

e. *The credit default swap*

That became quite interesting in the 1990s when the credit default swap was invented. The credit default swap you will know, as the instrument at the centre of the 2008 crisis. It was a transaction in which you agreed to lay off the risks associated with the non-repayment of a particular loan. When credit default swaps came into being, the question arose of whether they were gambling or insurance. If they had been gambling in Britain, they would have fallen to be taxed and regulated under gaming regulations. If they were insurance, they would have fallen to be taxed and regulated under the insurance regime. What were they?

f. *The International Swaps and Derivatives Association (ISDA) commissioned an opinion from a London QC. Those of you who have done that will know that you will quite often get the outcome that you want, which in this case was that credit default swaps were not either of these things. They were not gambling, so did not fall under the gaming regime; and they were not insurance, so did not fall under the insurance regime. That left begging the question of what these contracts actually were, but the fact that they were neither gambling nor insurance enabled them to operate largely outside of regulation and to avoid any tax pitfalls. Not to be shut out, the US followed with the Commodity Futures Modernization Act a year later, which enabled these contracts to be traded in the US.*

g. *The Big Short*

By that time, people had become engaged in what has now become known as 'the Big Short'. In 2006-,. salesmen like Fab Tourre of Goldman Sachs were promoting the Abacus transaction, which was a credit default swap on a synthetic collateralised debt obligation devised by hedge fund manager John Paulson, who had identified tranches of sub-prime mortgages that he thought were particularly likely to default. These swaps were being sold to people who were taking the opposite view of that particular transaction and were ready to believe that these instruments deserved the AAA rating that they received. It is perfectly clear that that was, in the sense Potts used, a gambling transaction. The words from the classic description in English law are two people taking opposite views on the outcome of the same event, with one being proved right and one being proved wrong.

V. Risks

1. Concentration

What was going on, in terms of risk transfer during this era of financialisation, was not the spreading of mutualisation of risk to any large degree. It was actually the concentration of risk, as you had a process of risk transfer, as in the Big Short, in which risk was transferred from people who had a pretty good understanding of what they were doing to people who had less, with the result that risk was effectively concentrated among the greatest fools. It was disappointing, in the end, that many of the greatest fools turned out to be within the world's largest banks.

2. Mutualisation

What I am describing seems to me to be the fundamental critique of financialisation, which is the way in which the financial sector has lost sight of its core purposes. I described those purposes as being operating the utility of our payments system; helping us manage our wealth over our lifetimes; achieving capital allocation in particular in relation to housing, infrastructure, business investment and commercial property development and management; and risk allocation, in the sense of mutualisation of the risks of ordinary day life.

3. Everyday Risks

Instead of having the discussion in Jackson Hole, if you were to ask people in Main Street or Oxford Street whether they thought that financial innovation over the last 20 or 30 years had made their lives more or less risky, they would assume that you had lost leave of your senses. The risks that actually concern ordinary people are not the risks they were talking about at Jackson Hole,;these were risks to do with equity market volatility, currency fluctuations and interest rate movements. These were risks that had been created within the financial sector itself, in the first place. These were the financial risks of which that these instruments aimed to minimise the costs

The risks that concern ordinary people are risks to do with redundancy and unemployment, relationship breakdown, accident and disaster, and new risks concerned with longevity. These are the risks that our financial system ought to be focusing on. Wider issues are those of how we can promote disruptive innovation in payments, how we can help households manage their wealth better, and how we can achieve the search and stewardship necessary for effective capital allocation. They are about how we can help people mitigate the risks of ordinary life. These for me are the purposes of finance. They are not what most of this secondary-market trading activity is actually set up to do.

VI. Regulations

1. Over-regulation

Let me finish with a few words about regulation. If I talk to an audience like this and raise these kinds of themes, the response is often, 'What we need is more regulation.' I do not think we need more regulation. I think we already have far too much financial services regulation. Regulation is at least as much part of the problem as it is the solution.

2. Regulatory Arbitrage

If you go back to my example of the credit default swap and ask how it came into being in the first place, the answer is that, Mr Potts, the QC who delivered that opinion, was in a sense right when he said that the initial credit default swaps were neither gambling nor insurance. The reason credit default swaps came into being was to exploit the difference between the capital requirements of the regulatory structure of the insurance sector and capital requirements of the regulatory structure of the banking sector. If you made a loan, you needed to provide capital against it based on the amount of the loan. If you took out an insurance policy, you needed to prescribe capital against it based on the expected loss. If you made a very large loan to ExxonMobil, which was the subject of one of the first credit default swaps, the risk of loss would be very low, but the size of the loan would be very large. You would be much better off, in effect, to treat it as an insurance policy, rather than a loan, and separate the risk from the lending component. That is what the credit default swap did. It was an instrument of regulatory arbitrage. It came into being to exploit complexities in the regulatory system.

3. Centralisation

A great deal of the complexity of modern finance is the product of that particular kind of exercise. We try to lay down rules from the centre. These then have unintended consequences and markets develop in order to circumvent or mitigate the impact of these rules. We then construct more complex rules to try to deal with it and that process goes on and on forever, and it goes on in a way that is more and more complicated and less and less effective. In truth, if that kind of structure would have worked, the Soviet Union would have worked. It is because we cannot run economies in that kind of way that centrally planned societies proved not to be very innovative or effective. I think we should regulate in quite different ways.

4. Separation of Functions

What we have done over this era of financialisation is to move from a world in which we tried to regulate the industry sector by silo-ing activities into separate kinds of institution to one in which we have laid down these prescriptive rule books, having abandoned restrictions on structure, and allowed the very large financial conglomerates that characterise the world today to emerge. With hindsight that was a mistake. What we need to do is go back, in my view, not just to ring-fencing retail banking and separating retail from investment banking, although that is an important start, but go on to recognise that, for example, the functions of the modern investment bank include securities issuance, corporate advice, market-making, own account trading, and asset management on behalf of retail and institutional clients, all of which are basically activities that conflict with every other. What we need is dedicated institutions that are focused on meeting particular consumer needs and which derive their profitability not from trading activities, but from their effectiveness in meeting the needs of the underlying users of financial services.

5. Personal Responsibility

At the same time, we need to reinforce the cultural changes that that is intended to bring about by having regimes that emphasise personal responsibility. At its simplest, if you take the bonus, you take the rap. It should not be a defence to charges of misconduct within the organisations of which people are in charge that ‘I did not know about the specific misconduct.’ That is the emphasis we need to make on personal responsibility. In my view, it is only if we adopt that kind of change of gear in regulatory philosophy that we are likely to put in place measures that will avert the next financial crisis. Since we are not going to, our prospects of averting the next financial crisis are, it seems to me, fairly remote.

6. Preparation

If I can end with a note of pessimism combined with a tinge of optimism, it is to say that what I see myself is doing is not writing a manifesto for how the next financial crisis can be averted. I think we have probably sold that pass, but I would like to hope that, when politicians are faced with a major financial crisis in the future, they will have rather more ideas and more ammunition in their pockets to deal with that crisis than they did when they had to deal with the crisis of 2008.

Questions and Answers

Lord Gordon

Is the concept of too big to fail itself flawed?

John Kay

The issue is less about too big to fail than too complex to fail. If you ask why the failure of Lehman was a problem in 2008, it was not because Lehman was big. It was not very big. It certainly was not because we needed Lehman to continue in operation. Since 2008, a lot of people have said that it was a pity that Lehman was allowed to fail. They are not saying that because they miss the services that Lehman used to provide. They are basically saying it because, when Lehman failed, it was at the centre of over a million outstanding financial contracts, so its failure had repercussions that reverberated around the whole financial system and which were insufficiently anticipated at the time of its failure. It is that complexity created by the financialisation process, in which so much financial activity involves trading with each other, rather than linear chains that go between the users of finance and the providers of finance, the savers whose money it ultimately is.

Helen Goodman MP

I am a Labour MP and Member of the Treasury Select Committee. After the crash, the Parliamentary Commission on Banking Standards recommended that senior managers be made responsible for anything that happened under them and that they needed to prove that they had not done the wrong thing, rather like a health and safety regime. Before that regime comes into force, the Government is bringing through the Bank of England Bill, which is going to reverse it. What do you think of that? Another thing that some Members of our Committee seem to pay a lot of attention to is the cap on bankers' bonuses that has come from Europe, which some people are very distressed about. I would like to hear your comments on those two questions.

John Kay

As I was hinting in what I said at the end, I am very much in favour of the Senior Managers Regime as it was initially formulated. If anything, I would like to put that on steroids. One of the problems is the formulation of that in the way you have described, which is to say that it is reversing the burden of proof. I would rather say that there is strict liability, which means that you are responsible for what goes on in your organisation. If you are in charge of a den of thieves that fact is an offence, and it is not a defence to say, 'I did not know it was a den of thieves. I thought it was a monastery.'

I am much more sceptical about the idea of capping bonuses. There are endless ways of getting around that. If the effect of that is to raise the base salary levels of people in the financial services sector, it is probably a step back, rather than a step forwards. What we need to do is to address the underlying sources of apparent exceptional profitability of financial services, which is what gives rise to the salaries and bonuses in the first place.

I do not have time to take you through everything in my book this morning, but the chapter that I most enjoyed writing was the one in which I posed and tried to answer the question; if this activity is not generating very much that is useful to the non-financial economy, why it is so profitable?. One of the answers to that is that a lot of the profitability was illusory. A caricature of what went on in the years 2003 to 2007 is that banks announced they had made very large profits, paid out a large share of them to their senior employees, and then discovered that it had all been a mistake, more or less wiped out their shareholders and relied on taxpayer support to recapitalise the institutions. Some of the profits are not really there.

What we need to do is have a much greater understanding of the sources of profitability and apparent profitability in financial services and address these. It is addressing the underlying causes of these bonuses and the risk-taking behaviour associated with them, rather than capping the bonuses themselves. That is attacking the symptom and not the problem. The largest thing we can do to start to undermine that appearance of profitability is to introduce the structural reforms to the industry, which I was describing.

Lord Sharkey

Before I take you to the next question, I should point out from Helen Goodman's question that Baroness Kramer, myself and John McFall tried to stop that happening, the reversal of the reverse burden of proof, in the House of Lords. We lost by two votes.

Mike Baliman, London Fintech Podcast

I almost entirely agree with everything you say, John. I joined the City 30 years ago and started in the days before the Big Bang at Kleinwort Benson. Could you talk a little bit about the words 'capitalism' and 'corporatism' and their role in this? When I started in the City, if we messed up a business, we would blow it up and lose our houses. These days, I am doing podcasts with people who are doing the same kind of thing playing with their own money. In the meantime, it seems to me that corporatism around the world is a large part of the problem, in particular how it corrupts the state.

John Kay

There are two issues raised in what you have said there. One is the transition from partnerships to limited companies, which happened in a range of areas of financial services in the 1980s. My view is that high-risk-bearing activities in the financial sector are best conducted either in partnership or by people who know what is being done with their money and are sophisticated enough to keep a close eye on the people who are managing it. I do not regard hedge funds as the villain of the piece in all of this. There is a role for hedge funds, because there is a role in stabilising markets for people willing to take speculative positions but, that should be a small part of total financial activity. It should not be the dominant part of it. When speculative activity of that kind becomes dominant, it tends to becomes destabilising rather than stabilising.

That kind of activity should certainly not be undertaken within large retail banks. I noted earlier that Deutsche Bank's derivative exposure is about 10% of the global total of $600 trillion. That is against a capital base of €50 billion and a deposit base of something like 10 times that. This is the most leveraged institution that ever there has been, which may be something to do with the market nerves that have been surrounding Deutsche Bank over the last few months.

The second point is on corporatism more broadly. The problems we are talking about this morning are not going to be as addressable, so long as the influence of the financial sector on politics remains as great as it is today, so long as the structure of campaign finance in the United States is as it currently is and so long as Wall Street is one of the two or three largest industrial lobbies in the United States. It is very hard to see how, given these facts, we can make effective progress towards financial reform.

I think that is a very large part of our problem and why the measures that were taken after the 1929--33 crisis, which was a very different political environment, were largely effective in the ways that the ones taken after 2008 are not going to be.

Chris Hewett, Finance Innovation Lab

I am interested in your structural reform points. Putting the party donation thing aside, put yourself in the position of the Chancellor next time there is a financial crisis, in the next few years. You have put forward these proposals and you say, 'We want serious structural reforms. We want to separate all the different functions of all the different banking institutions.' They will obviously say, 'We will leave the country.' They will raise the stakes. They will say, 'The City is very important to the United Kingdom economy. We will have to leave. You cannot do this.' If you were the politician in that position, what would you do in that situation?

John Kay

You are partly describing the situation now. Should we be worried when HSBC threatens to take its brass plate from London to Hong Kong? In my view, not much. Not very much goes with the brass plate, actually. There would still continue to be large operations in London that are not predicated on this being the global headquarters of HSBC.

That takes one to the larger question of what the contribution of the City of London is to the UK economy and how desirable it is. I go to events where I hear wildly exaggerated estimates of the amount of tax that financial services contribute to the UK Exchequer. Just to give you an illustration, the maximum corporation tax that has ever been raised from banks was between £6 and £7 billion at the peak of the boom, in 2006--7. Today, corporation tax from banks is about £1.5 billion, which is a 0.25% of total UK tax revenue. The bank levy, which is this very unsatisfactory and rather random charge we have imposed as an ad hoc device to get money out of the financial sector, raises about £2.5 billion. The main source of tax revenue from the City is actually PAYE on high earnings from people in the sector. The main effect of the City of London on the UK economy is that people are earning a lot of money, more than they would in alternative occupations, largely at the expense of foreigners. Many of them actually are foreigners, but they are foreigners who are resident in London.

That has positive impacts on the UK economy. I suppose the butlers that they employ have employment that they might not have and so on. What we need is a proper assessment of how much we actually value this activity.

I am talking in a slightly pejorative way, more than I mean perhaps, because the answer to this question does not seem obvious to me. It was my *Financial Times* colleague Martin Wolf who once said that, if you discover as a country that you have a competitive advantage in exporting toxic waste, what should you do. That exaggerates the situation in my mind, but it poses the dilemma. The aspect that most worries me is that when I was at school that the less bright boys in my class at school went on to financial services. By the time that I had finished teaching at Oxford, most of the brightest students who I had taught were looking for jobs in the City. I cannot help asking myself what the opportunity cost of these outstandingly able people having been employed in activities of doubtful social value has actually been.

Andrew McNally, Equitile Investments

You talked about a period of relative stability from the end of the Second World War until the early 1970s. Of course that was under a very different global monetary regime. To what extent do you think the changes in central bank doctrine and policy that we have seen since the beginning of the 1970s have played a role in financialisation, as you have described it?

John Kay

This financialisation process was the product of a combination of a variety of simultaneous developments. The globalisation of finance was driven by the collapse of Bretton Woods, in the first instance by the emergence of oil surpluses, when a great deal of financial activity became much more international than it had ever been before. There were technological changes that made the kinds of trading activities that I have been describing possible, in ways that were not true before. There were ideological and political changes, in the move back towards reliance on markets, where were associated with the changes in regulatory regimes, which I have been describing, and there were changes to the roles of central banks that followed from it.

In some of the more radical thoughts I have put forward in the book, at the end, I ask what exactly the role of central banks is in the modern world. I am not entirely clear that I know the answer to that question. We had discussions about what would actually happen in financial terms if the Scottish referendum vote had been yes. One of the EU obligations is to have an institution called a central bank. I have speculated, from time to time, that if we just put up a brass plate on George Street somewhere saying ‘Scottish Central Bank’, it might have satisfied this particular EU requirement and the real needs of the Scottish population.

Sarah Wilson, Manifest

The role of the Bank of England will probably be to issue new currencies under blockchain, in competition with JPMorgan. That might be one useful function. I want to return to the discussion about too big to fail and complexity. The flipside of that is too small to succeed and too simple. How do we help institutions that have been used to dealing only with very large institutions, which is seen as a safe, low-risk activity? You are asking for slightly more complexity in the ecosystem, by having more players, activities and specialism. At Big Bang, we had a lot of specialist individuals but, since that time, people seem to have lost the capacity to deal with multiple suppliers and participants in the marketplace. How do we facilitate that change? How do we move the agenda forward?

John Kay

I am not sure I quite agree with your diagnosis. I am not against retail banks being big. One of the advantages of having big retail banks in the UK in the 1930s was that we did not have bank failures, because we had large diversified banks, whereas the US has a fragmented bank system and had thousands of bank failures.

If we have a problem of competition in the retail banking sector at the moment, which we do, that is less because there are not enough banks, and more because all the banks we have are the same. It is impossible, as a retail customer, to distinguish between RBS and HSBC. The competition between Tweedledum and Tweedledee matters a lot to Tweedledum and Tweedledee, but it does not matter very much to anyone else. That is what we have t now and it is aggravated by regulatory requirements. We say that we want challenger banks, but a condition of being a challenger bank is that you have to look very much like an existing bank and hire people from existing banks in order to run your new bank. I am not surprised we are disappointed by the results of competition, in that sense.

In other areas, we need smaller specialists. I am not convinced that large corporations are incapable of dealing with a variety of different financial institutions. You hear across a whole variety of industries, telecoms, energy or whatever it is, that what consumers really want is a one-stop shop that will meet all their needs. The evidence for that proposition is extremely limited. We want a one-stop shop for our groceries, when we buy 50 items each of which are less than £5 in value, but when we go out and buy our clothes, furniture or anything that is very complicated, we pick and choose between different suppliers. That is what people do in relation to higher-value purchases and you can translate that observation right across the industrial scene.

Lord Sharkey

I am afraid we have now run out of time. I would like to thank John for his trenchant views and expression of them. I would also like to thank him for bringing to my notice the phrase 'the unimportance of being right', which is an enormous consolation to any politician.

Our next meeting will be on 20 April, when Rhydian Lewis of RateSetter will talk about innovative finance. On 3 May, Antony Jenkins, the former CEO of Barclays, will talk to us about cultural change in banking. John, thank you very much indeed.

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